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DOE FOR INTERNATIONAL AFFAIRS KDEUTSCH AND ALOCKWOOD
NSC FOR RICHARD MILES, DAN FISK
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STATE PASS TO FEDERAL RESERVE (CARLOS ARTETA)

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TAGS: [ECON](#) [ELAB](#) [EFIN](#) [EAGR](#) [PINR](#) [PGOV](#) [MX](#)
SUBJECT: CALDERON'S EFFORTS TO COOL INFLATION DRAW MIXED
REVIEWS

REF: A. MEXICO 5044

[1](#)B. MEXICO 391

Summary

[1](#)1. (SBU) President Calderon on September 26 announced several measures aimed at stemming inflation, including postponing the enactment of a new gasoline tax and freezing prices of gasoline, liquid petroleum gas, and electricity until yearend. Mexico's annual inflation rate has remained above the upper limit of the central bank's target range (4 percent) in eight of the past 12 months due largely to rising international food prices -- including staple items such as bread, tortillas, and eggs. Calderon cast the measures as a means to contain inflation, but many local observers have said his motivations were largely political. Some observers have criticized the measures, arguing that they will not contain inflation expectations and that Calderon will have to "take the heat" for the gas tax now and again in January. Others have applauded the announcement, saying that it will help calm existing "anxiety" about inflation stemming from non-food related sources. Post believes that the measures should not be seen as a departure from free-market policies, but rather as an attempt to deflect criticism about inflation and the gasoline tax. End Summary.

President Announces Measures to Combat Inflation

[1](#)2. (U) During a speech on September 26, President Calderon announced several measures aimed at stemming inflation and assisting low-income families. First, he postponed the implementation of a 5.5-percent tax hike on gasoline and diesel, included in the recently approved fiscal reform bill,

until January 1, 2008 (ref A). Calderon remarked that this tax hike was "unfortunately" discussed at a time of high international prices for key products such as wheat. (Note: We understand Calderon will simply not sign the fiscal reform bill until December so the gas tax won't come into effect until January 2008. End Note.) Second, he ordered a freeze on gasoline, diesel, liquid petroleum gas, and domestic electricity prices for the rest of the year. He added that the government would redouble its efforts to provide marginalized groups with high-quality basic products at a low cost, and he announced an agreement with a retailer association to keep "pan de mesa" (a category of bread) prices from exceeding one peso per piece. He also called on the media, unions, manufacturers, and other social, political, and economic actors not to make the situation worse by "serving their own interests." He acknowledged that the announced measures would impose a burden on government finances.

High Food Prices Lead to Inflation

13. (U) Concerns about inflation are not unwarranted. Mexico's annual inflation rate has remained above the upper limit of the central bank's target range (4 percent) in eight of the past 12 months, due largely to rising international food prices. In the first half of September, consumer prices jumped 0.62 percent fueled by a leap in fruit and vegetable, dairy, and back-to-school expenses. Low-income Mexicans are particularly sensitive to price increases in food products because they spend such a large part of their income on food, particularly staples such as bread, tortillas, and eggs -- products that have seen large price increases over the past

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year. Wheat price increases (resulting from, inter alia, Australia's drought and significant switching from wheat to corn production in the U.S. due to demand for ethanol) have received the most attention in recent weeks in Mexico.

Motivation and Reaction

14. (SBU) Although Calderon cast the measures as a means to contain inflation and inflation expectations, many local observers have said his motivations were largely political. Calderon appears to have been reacting to political pressure regarding the gasoline tax and general concerns about rising food prices. Opposition political parties have been vocal claiming that the gasoline tax would put further pressure on inflation and unfairly burden the poor (Comment: Many economists have said the tax's impact on inflation would be minimal since the tax will be implemented over an 18-month period. End Comment.)

15. (SBU) A senior Bank of Mexico (BOM) official and a Deputy Director from Banamex were critical of Calderon's decision to postpone the gasoline tax, qualifying it as a "political decision" inspired by a desire to duck criticism from popular sectors. The central bank official said he was not consulted about the decision. He added that from an inflation standpoint, the move was counterproductive, as speculation had already contributed to price increases. Capping prices artificially over the next three months would only mean they would spike dramatically in January. Neither official could understand the long-term political benefit. Calderon may escape criticism now but should expect opponents of the gasoline tax to come out strong with criticism come January when it is implemented. A Senator from the conservative faction of the PAN echoed these sentiments, noting that now Calderon will have to "take the heat" twice.

16. (SBU) By contrast, some financial analysts and members of the business community have applauded the announcement,

saying that it will help stop price speculation and calm existing "anxiety" about inflation stemming from non-food related sources. Larry Rubin from the American Chamber of Commerce stated publicly that Calderon's decision to contain energy prices this year was good news that would translate into better financial planning by companies. The BOM announced on September 28 that the measures will help anchor short-term inflation expectations and will bring down yearend headline inflation by around 9 basis points. When asked by econoff if Calderon's recent moves are alienating the business community, a local economist responded that businessmen understand that "some things are just for show."

Implications for Monetary Policy

¶7. (SBU) Before Calderon's speech, concerns about inflation had led many market analysts to predict the BOM will lift interest rates between 25 and 50 basis points by year's end. The BOM earlier this month held its benchmark lending rate unchanged, but kept its hawkish bias.

¶8. (SBU) According to a Bank of America economist who attended a meeting with Finance Secretary Carstens early this week, Carstens said he did not see a need for the BOM to raise interest rates again this year to mitigate inflation. The economist noted that while Carstens probably knew about the measures announced on 9/26, the economist was surprised. While some market analysts have said the measures will take pressure off the BOM to raise interest rates again this year,

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this economist still expects the BOM to hike rates by as much as 50 basis points by yearend. That said, he emphasized the importance of U.S. monetary policy decisions to Mexico by adding that if the Federal Reserve cuts rates again this year as many expect, Mexico would experience an "implicit tightening" of its monetary policy because the spread between U.S. and Mexican interest rates would be wider.

¶9. (SBU) The economist remarked that the BOM's ability to contain inflation is limited because its "tools" are not designed to deal with supply-side shocks. Several local observers have commented publicly that the most effective way to tackle inflation would be to level the playing field for competition in areas where the major Mexican and foreign companies are dominant, including telephones, broadcasting, energy, banking, and food processing and distribution. The prevalence of monopolies and oligopolies in Mexico reduces the efficiency and productivity of many sectors and keeps prices high.

Comment

¶10. (SBU) The measures Calderon announced this week should not be seen as a departure from free-market policies, but rather as an attempt to deflect criticism about inflation and the gasoline tax. The level of food prices, as well as any other issue that negatively affects Mexico's large poor population, are particularly sensitive topics, and Calderon would no doubt be happy to avoid the kind of political heat caused by tortilla price hikes early this year (ref B). Whether Calderon's decision to suspend the gas tax enables him to escape longer term criticism from Mexico's left and the poorer segments of society remains to be seen. He may well be facing the prospect for similar criticism in some months time, prompting a decision at that time about whether he is prepared to weather the political attacks or push the tax back again.

¶11. (SBU) Interestingly, the measures directly contradict something a Finance Secretariat (Hacienda) official related to econoff last week. This official explained how Mexico has

an "implicit subsidy" on the cost of gas because international prices currently are higher than the local price (which is a government administered price). He added that Hacienda wants to get rid of this "subsidy" since the government has to internalize the cost of the price difference and because it aims to keep gas prices stable, not necessarily low.

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